# INDEX



# CITATIONS

CASES:

## CITATIONS(Continued)

In The

# SUPREME COURT OF THE UNITED STATES

October Term, 1948

No. 866

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COMMISSIONER OF INTERNAL REVENUE,
*Petitioner*

v.

L. F. LONG
*Respondent*

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**ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT**

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**BRIEF FOR THE RESPONDENT IN OPPOSITION**

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## Opinions Below

The memorandum findings of fact and opinion of the Tax Court of the United States (R. 30-53) are not reported. The opinion of the Court of Appeals (R. 226-231) is reported at 173 F. 2d 471.

## Jurisdiction

The judgment of the Court of Appeals was entered on March 17, 1949 (R. 232). Petition for a writ of certiorari was filed June 14, 1949. The jurisdiction

of this Court is invoked under 28 U. S. C., Section 1254(1).

## Question Presented

Is a partner's interest in a partnership, engaged in the business of producing oil, a capital asset so that all of the profit from its sale is taxable as capital gain under *Section 117 I. R. C.*, or does the fact that the partnership owned non-capital assets (depreciable property used in its business, Section 117(a)(1) I. R. C.) require that some portion of the profit from the sale of the partnership interest be taxed as ordinary income.[1]

## Statutes Involved

The applicable portions of the statutes involved are set forth in the Appendix, *infra*, pages 20 to 22.

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[1]The Commissioner's Statement of the Question is inconsistent with the facts found by the Tax Court and affirmed by the Fifth Circuit Court. The Tax Court found that taxpayer sold his interest in the partnership, Joe Long Drilling Company (R. 29-44), and the Circuit Court said (R. 227) "* * * We believe the Tax Court was correct in holding that Long sold an interest in the partnership, a capital asset, rather than his share in each of the assets owned in partnership with his father and step-mother." Therefore, the statement under "Question Presented" in the petition, page 2, "* * * transferring his interest in certain of the partnership assets to the partners who continue the business" is an attack, not permitted in this Court, on a fact found by the trial court and affirmed by the intermediate court.

## Statement

After having been for several years a member of a partnership known as Joe Long Drilling Company (which partnership was engaged in the business of producing oil in Texas and owned capital and non-capital assets related to that business (R. 19)), taxpayer, L. F. Long, entirely terminated his connection with the partnership at the close of 1940 in this wise: He withdrew certain assets in kind,[2] and, contemporaneously, sold his partnership interest to his remaining partners (his father and step-mother), who continued the business with the assets as diminished by Respondent's withdrawal in kind (R. 37-40, 44, 227).

The deficiency, in so far as it relates to the question presented in this case, was determined upon the theory that there had been a complete dissolution of Joe Long Drilling Company at the close of 1940, followed by the sale by taxpayer of his interest in certain of the assets "acquired in the dissolution of Joe Long Drilling Company" (R. 18), and the retention of the remainder,—that is, the assets which, under taxpayer's theory, had been distributed to him in kind by the partnership (R. 18, 22). The Tax Court reversed this determination of the Commissioner, holding that there had been no such dissolution, distribution and sale, but that Long's partnership interest, a capital asset, was the subject matter of the sale (R. 44, 51). The Circuit Court affirmed (R. 227).

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[2]A limited overriding oil royalty or oil payment, a drilling rig and certain oil royalty interests (R. 38-39).

The petition (page 3) makes reference to certain assets of the partnership "which constituted the partners' stock in trade." (R. 19-20, 38, 41, 51). The record nowhere supports this classification. The partnership had no stock in trade,—that is property held for sale. The Commissioner evidently misunderstood the terms "Warehouse Stock" and "Stock" shown in a list of partnership assets at page 19 of the record. Warehouse stock, as there used, means oil lease equipment such as pipe, valves, tubing, rods, etc. held in the warehouse to equip oil wells or to repair oil well equipment and the "stock" referred to there was a small amount of stock in a corporation (R. 20). The whole record clearly shows that the partnership income came only from oil and gas produced from its leasehold and royalty interests.[3]

## Explanatory Statement

This case, and the wholly unrelated case of *Commissioner* v. *H. R. Smith*, 173 F 2d 470, affirming 10 T. C. 398, were submitted to the Court of Appeals upon the same date. The *Smith* case involved only the capital gain question under consideration here with

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[3]It is to be observed that the Joe Long Drilling Company, different from the partnership in the *Smith* case, possessed no asset which, if sold during taxable years beginning after December 31, 1941, would, under the facts here, result in the realization of ordinary income. The sale of any asset owned by Joe Long Drilling Company, under the facts, would, if made during the periods above mentioned, constitute the sale of a capital asset. See Section 117(j) of the Internal Revenue Code, Appendix, infra, pp. 21 to 22, added by the Revenue Act of 1942.

respect to the sale of an interest in a mercantile partnership. The Court of Appeals gave its reasons for affirming the Tax Court in its opinion in the *Smith* case, and, in this case, merely referred to that opinion to support its conclusion that an interest in a partnership was a capital asset (R. 227). The Commissioner filed Petitions for Certiorari in both cases on the same date, June 14, 1949. The Petition in the *Smith* case is styled and numbered — *Commissioner of Internal Revenue* v. *H. R. Smith*, No. 865, October Term 1948. The reasons urged for granting the writ are developed at length in the Smith Petition, while the petition in this, the Long case, does little more, in giving the reasons assigned for granting the writ, than to refer to the petition in the Smith case (Petition Long case, page 6). Therefore, the major portion of the argument which follows will be directed to the reasons for granting the writ as set forth in the Smith Petition at pages 6 to 17.

## Argument

1. As he did in stating the Question Presented (See note 1, page 2 supra), the Commissioner, in giving his reasons why a writ should be granted in the Long case, indirectly attacks the findings below. He states (Page 6 Petition Long case):

> "However, the taxpayer transferred to his former partners his interest in the remaining partnership assets * * * *. To that extent, the taxpayer sold his interest in those assets and the character of

the gain must be determined by the nature of the assets in which an interest was sold."

Since the Commissioner does not directly attack the findings below, and could not here, the question of whether the writ applied for should be granted must be determined in the light of the controlling fact found below. That controlling fact is that the taxpayer sold his interest in the partnership. The real question presented is, as heretofore indicated (page 2, supra) —whether an interest in a partnership can be partly a capital asset and partly a non-capital asset, because the partnership happens to own at the critical date assets, some of which come within the statutory definition of a capital asset, and some of which do not.

It is at once apparent, from an examination of the definition of a capital asset contained in *Section 117 (a)(1)* of the Code, that no asset can be in part a capital asset and in part a non-capital asset. It is equally apparent that the term "capital assets", as there defined, means any kind of property held by a taxpayer, except that specifically excluded in the definition, and that the statutory definition does not purport to exclude an interest in a partnership. Therefore, it appears that if there is such a property right as an interest in a partnership, that property right is by statutory definition a capital asset. In the light of the direct holding by this Court in *Blodgett* v. *Silberman*, 277 U. S. 1 (1928) that:

"It (an interest in a partnership) was merely an interest in the surplus, a chose in action. It is an

intangible and carried with it a right to an accounting."

and the holding of Texas Courts that:

> "A partner has no specific interest in any particular chattel or part of the firm property, but only in the proper proportion of the surplus of the whole after payment of debts, including amounts due the other partners." *Sherk* v. *First National Bank of Hereford*, 206 S. W. 507."

it would appear to be much too late seriously to contend that an interest in a partnership is not a particular type of property.[4] Were this not true, it would be difficult to understand why in his Regulations dealing with partnerships the Commissioner uses language such as:

> "When a partner retires from a partnership, or the partnership is dissolved, the partner realizes a gain or loss measured by the difference between the price received *for his interest* and the sum of

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[4]Equally in point is the decision of this Court in *United States* v. *Kaufman*, 287 U. S. 408 (1925). This case holds that the United States cannot enforce its priority as to taxes against partnership assets in order to collect a tax due from an individual partner, even though the individual tax was based upon his share of partnership income, but could reach only the interest of the partner in the partnership. In so doing, the Court followed an earlier decision which, as summarized by the Court, held inter alia "* * * and the rule was too well settled to be questioned that his interest in the partnership was his share in the surplus after the partnership debts were paid, and that such surplus only was liable for his individual debts."

the adjusted cost or other basis to him of *his interest in the partnership* plus the amount of his share in any undistributed partnership net income earned since he became a partner on which the income tax has been paid * * * * * * *." *Sec. 19.113(a)(13)-2 Regulations 103.* (Emphasis supplied)

2. The Commissioner first assigns the importance of the question as a reason why the writ should be granted (Pages 6 to 12 Petition, Smith case). His first ground is, briefly, that the question frequently arises because partnership interests are often sold or readjusted. This we admit.

He states that the holding below opens an avenue for tax evasion. In developing this thought, fundamental tax principles are wholly disregarded and the petition goes far afield factually. In the Smith petition, page 7, it is contended that the accounts receivable of the Smith partnership represented unrealized ordinary income, upon his share of which Smith had not been taxed, and that the holding of the Courts below had the effect of improperly allowing him to derive capital gain benefits on this anticipated ordinary income. But the facts are that Smith was taxable upon his share of the income earned by the partnership up to the moment he sold his interest; and that, in such a mercantile partnership, the gain from credit sales is reflected in income when the sale is made and the account receivable entered on the books. Therefore, Smith, in addition to reporting the capital gain from the sale of his partnership interest, reported in the same period his share of all income

earned by the partnership to the date of his sale. That the taxpayer in this, the Long case, reported his share of partnership profits for the entire year 1940 is sufficiently shown by the deficiency notice, which includes in Long's 1940 income his share of these profits as adjusted by the Commissioner (R. 18).[5]

Of course the profit derived from the sale of a capital asset is taxed on a lesser sum than an equivalent amount of ordinary income would be taxed. If that be tax evasion, the fault lies with Congress, who in 1921 first incorporated into revenue legislation the theory of taxing capital gain at a lesser rate than that applied to ordinary income, and did this, in part, because of the injustice of taxing at progressive rates, as if it were the income of the current year, the enhancement in the value of property which had occurred over a period of time, and, in part in order to encourage sales which would not otherwise be made, and to collect additional revenue which would not be available if the sales were not made. Practically all capital assets which are sold at a profit are those which would have produced ordinary income to the seller had he retained them, and which are expected to produce ordinary income to the purchaser. It is implicit in every capital gain transaction that the seller elected to realize on past enhancement at capital gain rates, rather than to hold the asset sold and realized ordinary income thereon from year to year. That is an election which Congress clearly

[5]See also, footnote 3, page 4, supra.

granted and the fact that it is availed of is not tax evasion.

In the *Smith* case, those who purchased Smith's interest will, if they are successful, realize ordinary income from the operation of the partnership. In the Long case, the purchasers of Long's interest will realize ordinary income therefrom as they continue to produce oil and gas from the properties of the partnership, and even if either of the continuing partnerships may have the benefit of an increased basis in the assets because of the price paid Smith or Long for the partnership interests, (but see, *Estate of Lowenstein*, 12 TC No. 90, decided May 4, 1949), that is the result inherent in every purchase of a capital asset.

The third reason assigned by the Commissioner in his "Importance of the Question" argument is the unsatisfactory state of the decisions of the lower courts upon the question presented. It might be a sufficient reply to point out that with one possible exception, which will be later discussed, they are unsatisfactory to him because, since 1935, they have unanimously and consistently been contrary to his contentions. The holdings in these cases are discussed at some length in the brief in opposition being filed in the *Smith* case, and for brevity, we will not repeat this discussion.

3. The Commissioner next contends (Smith petition pages 12, 15) that the Smith and Long decisions are

wrong. In so doing, he relies chiefly upon the fact that ordinary partnerships are not taxed, but that in such cases partnership income is taxable to the partners whether distributed to them or not. He points out that this "partnership" method of taxation is by statute extended to other groups such as syndicates, pools and joint ventures, and he repeats his argument, shown above to be wholly erroneous, that:

> "Congress certainly did not intend, as is true of the accounts receivable here, that a partner's interest in income which only remains to be collected by the firm should be able to be anticipated in the form of a lump sum payment taxable as capital gain." (Smith petition bottom page 13).

And, finally, he asserts that a further "vice" of the decision is that it rests on the nature of a partner's interest in a partnership under Texas law.

Congress now taxes, and has from the beginning taxed, some partnerships as corporations. *Cf. Burk-Waggoner Oil Association* v. *Hopkins*, 269 U. S. 110. There is nothing in the definition of a capital asset to require that an interest in a partnership taxed as a corporation, be treated as a capital asset regardless of the nature of the property owned by the partnership, while an interest in a partnership, the income of which is taxed directly to the partners, be treated as a capital asset or not, depending upon the nature of the assets owned by the partnership. Further, there is nothing in the cases of which the Commissioner complains to support his assertion that if an interest

in a partnership is a capital aset, the same classification must be applied to an interest in a pool or syndicate, merely because pools or syndicates are by statute permitted to file partnership returns for informational purposes. When such a case arises, it should, we submit, be decided by considering how the interest in the pool or syndicate, fits into the definition of a capital asset.

If the interest of a partner is directly in partnership assets and not (as this Court has held that it is) an intangible, the Commissioner can not support his regulation to the effect that when a partnership is dissolved the partner realizes a gain. See pages 7-8, *supra*. Nor can he, on the theory urged here by him, support his regulation to the effect that if in the distribution of partnership assets in kind, partnership money is distributed it can produce a gain.[6] The Commissioner himself has, therefore, recognized and treated an interest in a partnership as separate and distinct from an interest in its underlying assets.

Finally on this phase of the case, if the holdings attacked as wrong did not conform to the intention of Congress, the Commissioner has only his own failure to call the matter to the attention of Congress to blame. Congressional failure to remedy the situation constitutes Congressional approval thereof, particularly in the light of the fact that, not only have there been, since the first of these decisions was

[6]Sec. 29.113(a) (13)-2 Regulations 111.

rendered in 1935, several general revisions of income tax law, but the Capital Gain Section itself has been revised on at least three occasions.[7]

The simple fact is that the method which Congress has selected for taxing the income of partnerships has no bearing whatsoever upon the question of whether an interest in a partnership is or is not a capital asset. That question should be determined solely and only by considering the nature of a partner's interest in a partnership and the statutory definition of capital assets.

As to the Commissioner's attack upon the decision below on the ground "That it rests on the nature of a partner's interest in the partnership under Texas law" (Petition Smith case, page 14), and his argument that the uniform definition adopted by *Section 3797(a)(2)* of the Internal Revenue Code should control "to insure a uniform, nation-wide taxing scheme", it should be observed that the issue of Texas law was injected into the case by the Commissioner himself. This is clearly shown by the Tax Court's opinion in the *Smith* case, 10 T. C. 398, at 400:

> "The respondent contends that under the law of Texas, the sale by a partner of his interest in a partnership dissolves the partnership; that the Hyman Supply Company was dissolved at the moment petitioner sold his interest; that accordingly the petitioner sold and the purchasers received

[7]Revenue Acts of 1941 and 1942 and Individual Income Tax Act of 1944.

an undivided interest in the specific assets of the firm; and that the gain from this transaction should be taxed as ordinary income.

On brief the respondent recognizes that this and other courts have decided, under facts which do not differ materially from those here involved, that what was sold was a capital asset—an intangible consisting of a right to share in the value of the partnership after settlement of its afairs, and not an interest in the assets of the partnership as such. Dudley T. Humphrey, 32 B. T. A. 280; Commissioner v. Shapiro, 125 Fed. (2d) 532; Allan v. Lehman, 7 T. C. 1088, affd., 165 Fed (2d) 383; and Thornley v. Commissioner, 147 Fed (2d) 416.

The respondent attempts to distinguish the above cited cases from the instance proceeding on the ground that they were decided under the laws of states which have adopted the Uniform Partnership Act, whereas the facts of the instant proceeding disclose that the partners resided and the partnership engaged in business in the State of Texas, which has not adopted the act. * * * * We are unable to accept the respondent's argument that there is a material difference on the question as to the theoretical dissolution of a partnership by the withdrawal of a living partner in states where the Uniform Partnership Act is accepted and states where it is not in force.

Furthermore, the law governing partnerships in the State of Texas is not so materially different from the Uniform Partnership Act as to require a different conclusion in this proceeding from that

reached in the above cited cases. The Texas Courts have held that the interest of each partner in the partnership property is his share in the surplus after the partnership debts and paid, and after the partnership accounts are settled, and the rights of the partners *inter se* are adjusted; that a partner has no specific interest in any particular chattel or part of the property of the firm; and that a sale by one partner of his interest has the effect of dissolving the partnership."

By its decisions, the Tax Court and the Court of Appeals have produced uniformity of treatment of this question in Texas, as well as in those states which have the Uniform Partnership Act. Moreover, while *Section 3797(a)(2) supra*, defines what constitutes a partnership for certain Federal income tax purposes, it does not purport to reach the question here; to wit, how is the sale of an interest in such partnership to be treated for Federal income tax purposes. The alleged "vice" complained of by the Commissioner (Petition p. 14) simply does not exist.

4. The Commissioner next asserts that the decision conflicts with *City Bank Farmers Trust Company*, 47 Fed. Supp. 98, by the Court of Claims. We challenge the correctness of this assertion. Admittedly, this challenge is based to some extent upon inferences to be drawn from the Court of Claims findings of fact and opinion. The City Bank Farmers Trust Company case arose under the Revenue Act of 1936. Under this Act the gain from the sale of capital assets could not be taxed at a flat rate, as now, but varying

percentages of the gain were included as ordinary income, this percentage depending upon the length of time for which the asset sold had been held. Thus, if it had been held for not more than one year 100% of the gain was includable as ordinary income, but if the asset had been held for ten years or more only 30% was includable. The partnership interest involved in the *City Bank Farmers Trust Company* case was in E. A. Pierce & Company, a well known brokerage firm dealing in stocks and securities. The inference in which we indulge here is that the bulk of that firm's assets consisted of stock in trade, stocks, bonds and other securities held for sale to customers. If so, none of these assets would of themselves classify as capital assets, for *Section 117(b)* of the Revenue Act of 1936 expressly provided that the term capital assets:

> "* * * * does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

The question decided by the Court of Claims was not whether the interest in the partnership of E. A. Pierce & Company, which had been sold, was or was not a capital asset. The Commissioner had determined that it was. The disagreement was as to the period of holding. The taxpayers contended for a period of holding based upon the date the partnership interest

had been originally acquired. The Commissioner contended for varying dates depending upon when the assets on hand at date of sale had been acquired. Both parties admitted that what was sold was a capital asset. That, and that alone, is the question now before this Court. It might be contended that had the question been presented to the Court of Claims in the *City Bank Farmers Trust Company case*, the same reasoning would have upheld a decision that a partnership interest was wholly or partially a capital asset, depending upon the nature of the assets held, but we submit that it is incorrect to say that this Court of Claims decision conflicts with the holding in the *Long* case, and we submit that such an "in principle" conflict is not a sufficient reason for granting the writ here sought.

In this connection, the Commissioner urges that it is now possible, because of the *City Bank Farmers Trust Company decision*, for a taxpayer to choose his own forum and, when a gain has been realized from the sale of a partnership interest, to litigate where the case will reach Circuit Courts; but, when a loss is involved, litigate in the Court of Claims. There are two replies to this. One is that the proper time to seek a review here is when and if the Court of Claims has allowed a taxpayer an ordinary loss on the sale of a partnership interest held for the appropriate period of time. The second is that it is quite probable, in view of this Court's refusal to grant certiorari in *Commissioner* v. *Lehman*, 165 F. 2d 383, certiorari denied 334 U. S. 819, and the numerous decisions

unanimously in accord with that below which have been announced since October 5, 1942, when the Court of Claims decided the *City Bank Farmers Trust Company* case, that Court, if it had an opportunity to consider the question here presented would hold in accord with the decisions of all the other courts, as heretofore set out.

5. The instant petition is merely an attempt on the part of the Commissioner to have this Court reconsider the same question presented to it in the petition for certiorari in *Commissioner* v. *Lehman*, 334 U. S. 819, petition denied May 17, 1948. But nothing has happened since that date which, had it occurred prior to the submission of the petition in the *Lehman* case, would have caused this Court to give more weight than it did to that petition. On the contrary, as heretofore noted, and as pointed out in the brief in opposition in the *Smith* case, decision after decision has been rendered in accordance with and to a considerable extent in reliance upon this Court's denial of the petition in the *Lehman* case. Orderly administration of Revenue Law and a justified reliance upon the actions of this Court require that a limit be placed upon relitigation of the same question. The Commissioner should accept his defeat and, if he thinks the situation warrants it, apply to Congress for relief, rather than repeatedly to ask this Court to reconsider the self-same question.

## Conclusion

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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# APPENDIX

Internal Revenue Code:

Sec. 117. Capital Gains and Losses.

(a) *Definitions.*—As used in this chapter—

(1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1); * * *

(4) *Long-Term Capital Gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income;

* * * * * *

(b) *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized

upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66 2/3 per centum if the capital asset has been held for more than 18 months but not more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

* * * * * *

(j) Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.—

(1) Definition of Property Used in the Trade or business.—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k) and (1) or (2) is applicable.

(2) General Rule.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges or capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

(26 U. S. C. 1940 ed., Sec. 117).